No. 6856

IN THE

UNITED STATES CIRCUIT COURT OF APPEALS

For the Ninth Circuit.

October Term, A. D. 1932. 17

HARRY A. DAUGHERTY,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Petition for Review of Decision of United States Board of Tax Appeals.

BRIEF FOR PETITIONER.

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BRIEF FOR PETITIONER.

STATEMENT OF THE CASE.

This case is a petition for review of an order of the United States Board of Tax Appeals, redetermining petitioner's income tax liability for the year 1925. The order of the Board was entered on October 31, 1931, (Rec. p. 25), and the petition for review by this Court was filed on February 11, 1932, (Rec. p. 25), pursuant to Sections 1001-1003 of the Revenue Act of 1926.

The question is whether $47,180.28 received by petitioner's wife from third persons in 1926, pursuant to an assignment in 1924 by petitioner to her of an interest in a contract which produced the income, was income of petitioner.

The majority of the Board held that the amount was taxable income of petitioner. Two dissenting members of the Board expressed the opinion that the *res* which gave rise to

the income was assigned and that the income was not taxable to Petitioner. (Rec. p. 24).

In all years subsequent to 1915, petitioner was employed as one of the general attorneys for Standard Oil Company of Indiana, with an office in the general offices of that company. He was not engaged in the general practice of law but devoted all his time to Standard Oil Company of Indiana. (Rec. p. 16-17).

On November 1, 1923, Mr. John G. Campbell, who with his partner, Mr. Herman A. Fischer, Jr., had in 1912 been opposed to Petitioner in a matter concerning Mrs. Estelle G. Howland (Rec. p. 16), told petitioner that Mrs. Howland had a possible interest in a trust estate of John D. Jennings arising from the death of Mr. Jennings' son on October 31, 1923. (Rec. p. 17).

Petitioner told Campbell that he would ascertain the wishes of Mrs. Howland regarding the matter, but that, as stated in the Board's Findings of Fact, Rec. p. 17, "in no event could he handle litigation for her, because his position with the Standard Oil Company of Indiana occupied all of his time and attention. It was orally agreed between Campbell and petitioner that petitioner would not engage in any of the litigation, but that petitioner was simply to furnish the client." Mrs. Howland conferred with petitioner on November 3, 1923, as to which petitioner testified, Rec. p. 33:

> "I told her the situation and that 'I was not in a position to handle the litigation, could not do it on account of my connection with the Standard Oil Company, but I said: "Mr. John Campbell, who was the attorney for the Trust Company in the litigation you had before, is a very capable lawyer and so is his associate, Mr. Fischer, Herman Fischer, and men of high standing here; I have the utmost confidence in them, and if it is agreeable to you, I will have them handle the matter and I will have nothing further to do with it and they will be responsible for the litigation".' She said: 'If you have confidence in them, that is entirely satisfactory to me, and I appreciate the position you are in'."

The Findings of Fact state, Rec. p. 17:

> "At a conference between Mrs. Howland, her husband, and petitioner and Campbell at petitioner's offices in the Standard Oil Company building in Chicago, it was agreed that a bill to construe the will should be filed; that all of the work in connection with the proceedings should be performed by Messrs. Campbell and Fischer, and that there should be paid to the attorneys an amount equivalent to 40 per cent of whatever might be recovered for Mrs. Howland, this amount to be divided equally between Campbell, Fischer, petitioner, and R. J. Folonie, whose name was suggested by petitioner because of his connection with petitioner in the prior unsuccessful litigation for Mrs. Howland."

A contract between the four attorneys and Mrs. Howland was executed in quadruplicate, by which the attorneys would receive 40 per cent of any amounts recovered for Mrs. Howland.

The Findings of Fact state, Rec. p. 19:

> "It was agreed between the attorneys and Mrs. Howland that petitioner and Folonie would be required to do no work whatever in connection with the case.
>
> "(16) On November 3, Campbell and Fischer filed the bill to construe the will. There were numerous parties to the litigation and a great deal of time and effort was put on the case by Campbell and Fischer. No time whatever was put in on the case and no work of any kind was done on the case by petitioner or by Folonie, although Campbell signed petitioner's and Folonie's names to the pleadings in the litigation."

On January 30, 1924, petitioner wrote a letter to his wife, enclosing his copy of the contract on the margin of which he had executed the following assignment (Rec. p. 19):

> "Chicago, Ill., Jan. 30, 1924.
>
> "In consideration of love and affection, I hereby assign to Elizabeth M. Daugherty, my wife, an undivided one-half of my interest in and to this contract.
>
> Harry A. Daugherty."

The letter was in affectionate terms, stated what the contract related to, and also stated: "I want you to feel at liberty to use the money in any way you see fit." (Rec. p. 20-21).

The letter and contract were on January 30, 1924, delivered to petitioner's wife and thereafter always retained by her. Campbell was advised of the assignment. (Rec. p. 20).

At the time of the assignment, the litigation was pending and undetermined, "no settlement had then been arrived at and there was no assurance that the litigation would terminate successfully or that any settlement could be made. At the time of the gift the value of petitioner's interest in the contract and the value of the interest transferred by petitioner to his wife was wholly contingent and undeterminable." (Findings of Fact, Rec. p. 21).

> "In June, 1926, as a result of negotiations between the parties, in which petitioner in no way participated, a settlement of the litigation was agreed upon, * * *. Pursuant to the contract of employment, 40 per cent thereof, or $377,442.24, was duly paid to Campbell and Fischer. * * * On June 22, 1926, Campbell delivered to petitioner a check in his favor in the amount of $47,180.28 and a check in favor of Mrs. Daugherty in the amount of $47,180.28." (Findings of Fact, Rec. p. 21).

Petitioner's wife received her check, and petitioner never thereafter had the proceeds or control thereof. She did not contribute in any way to the household expenses nor did petitioner benefit in any way whatsoever from the proceeds his wife derived from the assignment. (Rec. p. 22).

The Commissioner of Internal Revenue held that the amount of the check received by Mrs. Daugherty was taxable income to the petitioner for 1926 and the majority opinion of the Board of Tax Appeals affirmed this action on the part of the Commissioner.

ERRORS RELIED UPON.

The errors assigned in the petition for review herein and upon which the petitioner relies are as follows:

> "1. Upon the findings of fact made by the Board of Tax Appeals, the Board erred in not holding as a matter of law that the amount of $47,180.28 received in 1926 by the wife of petitioner was not income taxable to the petitioner.
>
> "2. Upon the undisputed evidence presented to the Board of Tax Appeals, the Board erred in not holding as a matter of law that said amount of $47,180.28 paid to petitioner's wife in 1926 did not represent taxable income to petitioner.
>
> "3. The Board of Tax Appeals erred in failing to find from all the evidence that the amount of $47,180.28, paid to the wife of petitioner in 1926, did not constitute taxable income to petitioner."

BRIEF OF THE ARGUMENT.

The sole question for decision in this case is whether the amount of $47,180.28, received in 1926 by Mrs. Daugherty, wife of petitioner, constitutes income taxable to the petitioner, Harry A. Daugherty. Petitioner concedes that the amount actually received by him is taxable to him, and also that the amount received by Mrs. Daugherty is taxable to her, but contends that no income tax is payable by him on the amount received by Mrs. Daugherty.

Section 213 of the Revenue Act of 1926 provides in part as follows:

> "213. * * *
>
> "(b) The term 'gross income' does not include the following items, which shall be exempt from taxation under this title:
>
> * * *
>
> "(3) The value of property acquired by gift, bequest, devise, or inheritance (but the income from such property shall be included in gross income); * * *."

This section of the statute makes it clear that when a person makes a gift of property or of an interest in property which produces income, the income from the property so assigned is taxable to the assignee and not to the assignor. When petitioner made a gift to his wife of a one-half interest in the contract in question, no income tax was payable by Mrs. Daugherty because of the receipt of the contract, as the section of the statute just quoted provides that the value of property acquired by gift does not constitute gross income. The income which she received through the contract, however, was taxable as income to her under the statute and, being taxable to her, of course, did not constitute income taxable to petitioner.

The Federal income tax laws have been drawn so as to impose a tax upon the person who receives income. When income is received by an individual as the result of his personal services, the income is taxable to him. When he receives income from property owned by him, it is taxable to him. If a person owning income producing property parts with his title to such property, the income thereafter is no longer taxable to him. If he parts with an interest in the property producing the income, he is no longer taxable upon the income received from that part of the property which he has transferred. On the other hand, if he merely makes an assignment of the income, without relinquishing title to the property producing the income, the income is still taxable to him because, as a matter of law, he is still the owner of the property producing the income. This principle runs through all of the cases which have been before the courts where the question for decision was whether income was taxable to the assignor or the assignee.

The case at bar falls within the first classification mentioned,—that is, cases where the assignor parts with an interest in the property producing income. Petitioner had an interest in a contract. This contract constituted the *res*. He assigned a one-half interest in this contract to his wife. The contract provided that under certain conditions a certain amount of money would be payable. The wife of the petitioner, two years after the assignment was made, received the sum of $47,180.28 as a result of the assignment. The contract was not one which required the performance of any services upon the part of the petitioner. The Findings of Fact of the Board state (Rec. p. 19):

> "It was agreed between the attorneys and Mrs. Howland that petitioner and Folonie would be required to do no work whatever in connection with the case."

Under these circumstances, the amount received by Mrs. Daugherty was taxable to her and not to the petitioner. This principle is laid down in a number of decided cases.

In *Copland* v. *Commissioner of Internal Revenue,* 41 Fed. (2d) 501 C. C. A. 7, Epstein, Mayer and Copland executed a written contract, by which they agreed to underwrite the sale of certain shares of the North American Oil & Refining Corporation, profits and losses to be divided equally among them. Thereafter, Copland endorsed on his copy of the contract an assignment to his wife of all of his right, title and interest therein. At that time no profits had accrued under the contract. Copland was not required to perform any services whatever in connection with the underwriting, and he performed none. When the syndicate was closed, there was a substantial profit which the syndicate manager distributed in shares to himself, Epstein and Copland's wife. The sole question in the case was whether Copland should be taxed on the sum paid to and received by his wife. The Circuit Court of Appeals reversed the Board of Tax Appeals and held that the income derived from Copland's assigned interest was taxable to his wife and not to him. The decision was specifically put on the ground that the assignor had completely divested himself of the property interest assigned. The Court emphasized that the transfer included not simply the profits but the thing that would produce the profits. The Court further stated that it was immaterial that the assignor remained liable for the syndicate losses. The Court stated:

> "It is essential to a gift *inter vivos* that it be absolute, irrevocable; that the giver part with all dominion and control over the property; that the gift go into effect at once and not at some future time; and that there be a delivery to the donee, and such change of possession as puts it out of the power of the donor to repossess himself of the property. *People* v. *Csontos,* 275 Ill. 402, 114 N. E. 123. In the instant case there were no conditions to the gift; it was absolute; it became immediately effective; there was a delivery to Mayer for the donee, and at that time it became irrevocable, and the donor was powerless thereafter to repossess himself of the corpus of the gift."

There is no basis for distinction between the case at bar and the foregoing decision.

In *Iowa Bridge Co.* v. *Commissioner of Internal Revenue,* 39 Fed. (2d) 777, C. C. A. 8, a bridge construction contract was assigned and the Court held that the income subsequently derived therefrom was taxable to the assignee but not to the assignor.

In *Nelson* v. *Ferguson,* 56 Fed. (2d) 121, C. C. A. 3, the Court held that the assignor was not taxable on the income subsequently received by the assignee, his wife, from an assigned interest in a contract. The contract provided that the assignor should receive certain profits in consideration of a transfer of a patent by him to his employer. The Court first held that the contract was property, although the amount of the profits to be derived therefrom was uncertain. The Court then held that, the contract being property, the assignor could assign his interest therein to his wife and that income subsequently derived therefrom was income of the assignee. The Court distinguished cases of other types, as follows, page 124:

> "In answering these questions it must be kept in mind that the thing assigned was not Nelson's future salary or personal earnings as in the Earl Case and in the later case of *Luce* v. *Burnet, Commissioner,* 55 F. (2d) 751, Court of Appeals of the District of Columbia, January 18, 1932, things not then in existence, 5 Corpus Juris, 87, but was an existing thing, namely: property in a contract. The assignment being of property was therefore not merely an assignment of income when earned, though from the property assigned profits and income were expected to flow. Following the reasoning in the like case of *Hall* v. *Burnet* (Court of Appeals of the District of Columbia, November 16, 1931), 54 F. (2d) 443, the assignment was not of future earnings of the assignor arising out of his future services, as in the Earl and Luce Cases, but was distinctly an assignment of a property right presently existing. Though the future income from this property right was uncertain and contingent as to

amount, the right itself, the thing assigned, was fixed and certain—not revocable as in *Corliss* v. *Bowers,* 281 U. S. 376, 50 S. Ct. 336, 74 L. Ed. 916—and was independent of any future service or any future action on the part of the assignor. We hold it was clearly assignable to a stranger and, if so, it was, subject to the next question, assignable to the wife. Whether to a stranger or wife, we think the income from it should have been taxed to the assignee, not to the assignor who had ceased to own or control it, * * *."

In *Hall* v. *Burnet, Commissioner,* 54 Fed. (2d) 443, C. of A., D. C., Certiorari Denied by the Supreme Court of the United States, 285 U. S. 552, the Court held that where an insurance agent assigned to his wife a part of his interest in the commissions payable in the future but already earned, the assignor was not taxable on the income thereafter derived from the interest in the contract assigned to the assignee. The Court held that the assignment was of a property interest in the form of an interest in the contract, which interest produced the income in question. The assignment was absolute because the right to the income under the contract did not depend upon future personal services of the assignor. The Court of Appeals stated, page 444:

"It was not an assignment of future earnings but the transfer of a property right, and though this property right gave rise to future income, uncertain and contingent though it might be as to amount, that fact does not destroy the distinction. In this case, the contract between appellant and the insurance company gave him a property right in all renewal premiums on all business written for the company by him or by others during the period of the contract. Undoubtedly, his right to these commissions would survive his death and would pass to his estate to the same extent and in the same way as other property which he then possessed. In these circumstances, it is obvious that the right was fixed and certain, and was independent of any future service to be rendered by him."

The four cases just cited, decided by the Circuit Courts of Appeals for the Seventh, Eighth and Third Circuits and by the Court of Appeals of the District of Columbia, respectively, present exactly the same question that is involved in the case at bar. Each of them is a case involving an absolute assignment of an interest in a contract where income was received by the assignee as a result of the assignment. In each case it was held that the income subsequently derived from the assigned interest in the contract was not the taxable income of the assignor. We do not believe that any distinction can be made between the issues presented in those cases and those presented in the case at bar.

The decision of the Board in this case was based very largely upon the decision of the Supreme Court in the case of *Lucas* v. *Earl,* 281 U. S. 111. In that case Earl and his wife in 1901 agreed that "any property either of us now has or may hereafter acquire * * * in any way, either by earnings (including salaries, fees, etc.), or any rights by contract or otherwise, during the existence of our marriage * * * shall be treated and considered and hereby is declared to be received, held, taken and owned by us as joint tenants and not otherwise, with the right of survivorship." A question arose as to whether salary and attorneys' fees earned by Earl in 1920 and 1921 were taxable to him in full or whether he was taxable only upon one-half thereof. The Supreme Court held that Earl was taxable upon the full amount received by him. The basis of the Court's decision in *Lucas* v. *Earl* is well summarized by the Circuit Court of Appeals for the Third Circuit in *Nelson* v. *Ferguson,* 56 Fed. (2d) 121, as follows:

> "That case deals exclusively with the assessment of a tax upon moneys to be received by a husband in payment for his personal services. The contract between Earl and his wife was made in 1901; the services were rendered and moneys paid in 1920 and 1921. It provided for the commingling of all the earnings of both spouses

> and for holding the same as joint tenants. It dealt with future earnings, extending in that case twenty years. There was no existing thing, tangible or intangible, to which at its execution the contract could presently attach. It was therefore an executory contract based upon mutual promises in respect to things not yet in existence. One-half of the husband's earnings never could be paid to the wife unless and until earnings had accrued to him on account of things he had done, services he had rendered. Earl and his wife were anticipating the future and dealing with the potential income of each other, which, before it reached either of them, must come to and pass through the other, and in doing so it would, for an instant at least, fall under the taxing act, and this because the assignment in that case was bottomed on the fact that the earnings would come to the husband and be his property else there would have been nothing on which it could operate. This seems to be the central point of the Earl Case not only as expressed in the opinion in that case but as restated in the opinion in *Poe* v. *Sanborn,* 282 U. S. 101, 117, 51 S. Ct. 58, 75 L. Ed. 239. There the assigned income sprang from services which were not property and which of course could not be assigned. Here the income sprang from assigned property and, if validly assigned, the income was that of the assignee, the owner of the property, and was taxable as hers."

As pointed out by the Court in the *Earl* case, there was no contract to which an assignment could attach and no *res* or property which was susceptible of assignment. It was, in effect, nothing but a contract between the parties for the division of income. Under these circumstances, the money received was in the first instance the income of the party rendering the services and the arrangement between Earl and his wife was nothing more than a contract by which the husband agreed to give to his wife a share of his income after it was earned. In the case at bar, there was a contract which had value and which constituted a property right of the petitioner. This was assigned to petitioner's wife and the income derived from that interest in the contract was the income of Mrs. Daugherty.

As set out in the Findings of Fact of the Board of Tax Appeals, above quoted, the amount received by Mrs. Daugherty was not received by virtue of the performance of personal services by the petitioner, which also distinguishes the case at bar from the *Earl* case. Under the agreement, petitioner was not required to perform personal services and, in fact, he rendered none. Petitioner never received any income, constructively or otherwise. In the *Earl* case, the compensation which was paid was actually received in the first instance by Earl and the only basis for contending that it was not taxable to him was that under the agreement made with Mrs. Earl he paid one-half of it over to her after it was received by him.

There is an important distinction that should be noted between the case at bar and cases involving assignments of income to be received for personal services rendered by the assignor. In the latter cases, the assignee has no enforceable right of any kind because it is at all times within the power of the assignor to render the services or not, as he sees fit. If he does not perform the services, no income is derived and no property right assigned which can be enforced. Where the contract does not involve the performance of personal services and the assignment is of a property right, all control passes from the assignor at the time of the assignment and the assignor has no control whatever over the income thereafter earned.

Other cases of assignments of income illustrate the distinction between mere assignments of income and an assignment of an interest in the property producing the income. The case of *Bing* v. *Bowers,* 22 Fed. (2d) 450, involved a situation where there was an assignment of a given amount from the *net* rentals received by the assignor from real estate. The Court held that since the assignment was of *net* rents from which certain deductions had to be made, the income was in the first instance the property of the assignor

and taxable to him. The Court held in this case that there was no transfer to the assignee of any interest in the property itself but merely an assignment of income after it was received by the assignor. The Court concedes that if there had been a valid assignment of an interest in the property, the income would have been taxable to the assignee.

A number of cases have come before the courts involving assignments of partnership profits. In those cases where a partner simply made an assignment of profits to be earned by the partnership, the courts uniformly have held such profits taxable to the assignor, on the theory that the profits were first earned by the individual who was a member of the partnership. Of this type of case is *Luce* v. *Commissioner,* 18 B. T. A. 923, cited by the Board of Tax Appeals in its decision in the case at bar. See also *Burnet* v. *Leininger,* 52 S. Ct. Rep. 345; *Mitchel* v. *Bowers,* 15 Fed. (2d) 287; *Harris* v. *Commissioner,* 39 Fed. (2d) 546; *Cohan* v. *Commissioner,* 39 Fed. (2d) 540; *Ellis* v. *Commissioner,* 25 B. T. A. 1195. On the other hand, in those cases where there was a transfer of the partner's interest in the partnership, rather than of his distributable share of the income, the courts have held that the assigning partner is not subject to tax upon the income subsequently derived from the assigned interest in the partnership. In these cases the assignee acquires an interest in the *res* and the income therefrom is taxable to the assignee. *Commissioner* v. *Barnes Estate,* 30 Fed. (2d) 289; *Hellman* v. *United States,* 44 Fed. (2d) 83; *Crane* v. *Commissioner,* 19 B. T. A. 577.

In the case of royalties, if the assignment passes an interest in the property producing the royalties, the royalties are taxable to the assignee and not to the assignor. *Browning* v. *Commissioner,* 16 B. T. A. 485; *J. V. Leydig* v. *Commissioner,* 43 Fed. (2d) 494.

Where there is an assignment of the income of a trust by a beneficiary, the income is taxable to the assignor and

not to the assignee. Where, however, the assignment is such as to amount to a disposition of the interest of the beneficiary in the corpus of the trust estate, the income then is taxable to the assignee. *Shellabarger* v. *Commissioner,* 38 Fed. (2d) 566 (C. C. A. 7); *Commissioner* v. *Field,* 42 Fed. (2d) 820 (C. C. A. 2); *Blair* v. *Commissioner,* 18 B. T. A. 69; *Clark* v. *Commissioner,* 16 B. T. A. 453.

We know of no reported cases which impose a tax upon an assignor where he has made an absolute assignment of the *res* which produces the income. All courts which have passed on the question have held the income in such cases taxable to the assignee. This Court recognized this principle in the following language in the case of *Wehe* v. *McLaughlin, Collector,* 30 Fed. (2d) 217:

> "It may be conceded that, by a gift from one spouse to the other of his or her interest in existing community property, the entire estate is converted into the separate property of the donee, and that thereafter the income therefrom is returnable by such donee alone."

While the court was here speaking of community property, the principal involved would be the same in the case of property other than community property.

One further point should be noted. There has not been and cannot be on the record in this case any suggestion that the gift from the petitioner to his wife had any "strings" attached to it. The evidence shows that it was a bona fide gift and the proceeds received by Mrs. Daugherty therefrom were used by her alone. The Findings of Fact of the Board state (Rec. p. 22):

> "Mrs. Daugherty deposited (or caused to be deposited) this check in an account which she opened in the Illinois Merchants Trust Company, a downtown bank in Chicago. She invested the money in stocks, secured the certificates in her own name, and deposited them in her private safe deposit box. She used the dividends of the stocks entirely for her own purposes and she did not contribute in any way to the household expenses,

> nor did petitioner derive any benefit whatsoever from the money paid to his wife nor from the dividends received by Mrs. Daugherty on such securities."

At the time the assignment was made, in January, 1924, less than three months after the contract was made, the litigation was pending and undetermined. No settlement had then been arrived at and there was no assurance that the litigation would terminate successfully or that any settlement could be made. At the time of the gift, the value of petitioner's interest in the contract and the value of the interest transferred by petitioner to his wife were wholly contingent and undeterminable (Findings of Fact, Rec. p. 21).

CONCLUSION.

It is respectfully submitted that the petitioner in this case made an absolute assignment of the contract in question and divested himself of the right to receive income therefrom. The income, when received by the assignee, was the income of the assignee and not of the petitioner. Under the principles laid down in the cases which have been cited, it is respectfully submitted that the decision of the Board of Tax Appeals should be reversed.

Respectfully submitted,

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